REAL ESTATE & INFRASTRUCTURE | TAX ALERT

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NEWLY-ENACTED ECONOMIC OPPORTUNITY ZONE PROGRAM OFFERS SIGNIFICANT TAX BENEFITS TO INVESTORS

One provision of the Tax Cuts and Jobs Act (TCJA) that flew under the radar until recently is the new "Opportunity Zone" program. The Opportunity Zone program is designed to promote investment in specific economically-distressed communities selected by the states and approved by the IRS.

Taxpayers receive significant tax benefits by investing in a Qualified Opportunity Fund ("QOF") which, in turn, invests the capital in pre-designated Opportunity Zones. Specifically, a taxpayer may sell an asset and reinvest the net gain in a QOF.

The investment of the net gain in a QOF can:

- Temporarily defer tax on the gain
- Potentially eliminate up to 15% of the tax on the deferred gain
- Exclude from tax the future appreciation on the net gain invested

Who can benefit?

If a taxpayer owns an appreciated asset, such as real estate, the taxpayer can sell the property to an unrelated third party and re-invest the gain in a Qualified Opportunity Fund. The re-investment must be made within 180 days of the sale. An affirmative election is required to defer the gain. Note that the taxpayer does not have to reinvest all the sale proceeds, only an amount equal to the net gain.

For example, if a taxpayer bought a piece of land for $100 that is now worth $300, the taxpayer can sell the property and reinvest the net gain of $200 in a QOF. The taxpayer only needs to reinvest $200, not the entire $300 of sale proceeds. This is quite different from the "like-kind exchange" rules which require all sale proceeds to be rolled over into another piece of replacement real property. Also, because the Tax Cuts and Jobs Act limited "like-kind exchanges" to only include real property, the Opportunity Zone program is very attractive for taxpayers with highly-appreciated, non-real estate assets now disqualified from like-kind exchange treatment.

It is important to keep in mind that the sale of the appreciated property must not be to a related party. Generally, two parties are related for this purpose if there is a more-than-20% ownership overlap. The related party rules are quite broad and generally include entities owned by an individual and another member of the taxpayer's family.

How long can a taxpayer defer the gain on the sale of a property and how much of the deferred gain must be recognized?

A taxpayer defers the net gain invested in the QOF until the earlier of: the date the investment in the QOF is sold or exchanged, or December 31, 2026, (even if the taxpayer still holds the investment in the QOF at that time).

The gain recognized will be: the lower of (i) the deferred gain or (ii) the fair market value of the investment on that date, *minus* the taxpayer's basis in the investment.

How does the taxpayer calculate basis in the QOF investment?

A taxpayer's basis in the QOF starts out at zero, given the taxpayer is only required to invest unrecognized gain in the QOF. Any additional amounts contributed to the QOF above the net gain will also be included in the taxpayer's basis. In addition, the taxpayer's basis in the QOF will be increased by 10% of the original deferred gain if the taxpayer holds the QOF investment for five years, and by another 5% of the original deferred gain if the investment is held for a total of seven years. As a result, a taxpayer will only need to recognize 85% of the deferred gain if held the full seven years.

Thus, in our example above, where the taxpayer invested a $200 net gain into a QOF, the taxpayer would only pay long-term capital gains on $170 of the $200 deferred gain if the investment is held at least seven years, as follows.

Initial Basis	$0
Basis Increase if Hold 5 Years:	$200 x 10% = $20
Basis Increase if Hold 7 Years:	$200 x 5% = $10
Total New Basis after 7 Years:	$30
Original Gain less New Basis:	$200 – 30 = $170 Gain

It is important to note that investments in QOFs must be made by 2021 to receive the initial 10% increase in basis and by 2019 to be eligible for the additional 5% increase in basis.

Permanent gain exclusion

If a taxpayer holds the investment in the QOF for at least 10 years, the taxpayer can exclude appreciation on the asset. Again, using the above example, the taxpayer's investment of $200 in the QOF would grow tax free if the investment is held for 10 years.

Note the taxpayer must still recognize the original deferred gain by the end of 2026, reduced by the 15% basis adjustment, as applicable. Thus, provisions need to be made to provide liquidity to the taxpayer(s) in the QOF to pay these taxes in 2026.

If a taxpayer invests cash in a QOF greater than the gain, such investment is treated as a separate investment. As a result, any future appreciation on this separate investment will not be eligible for the permanent gain exclusion.

Can taxpayers enter into joint ventures with QOFs?

Property that is already in a Qualified Opportunity Zone ("QOZ") may not be contributed to a QOF. The investment in a QOF must be in the form of cash resulting from a sale of property to an unrelated third party. The QOF must purchase the property from an unrelated party.

What can a QOF invest in?

A QOF is an investment vehicle organized as either a corporation or a partnership with at least 90% of its assets in QOZ property that was purchased after December 31, 2017. QOZ property may be stock, partnership interests or business property.

QOZ Stock and QOZ Partnership Interest. A QOF can invest in a domestic corporation or domestic partnership that is a QOZ business. The taxpayer's investment must be made in cash either for stock or a partnership interest at the time of its original issuance. A QOZ business is a trade or business that:

- Substantially all its owned or leased tangible property is QOZ property (i.e. a QOF can't own intangible property);
- Derives 50% of the gross income from the active conduct of a trade or business in the QOZ;
- Is not a commercial golf course, country club, massage parlor, liquor store, hot tub facility, suntan facility, race track or another QOF; and
- A substantial portion of any intangible property is used in the QOZ business and owns only a limited amount of nonqualified financial property.

QOZ Business Property. QOZ business property is tangible property used in a trade or business, located in a QOZ, purchased after December 31, 2017, and either the "original use" of the property starts with the QOF or the QOF "substantially improves" the property.

"Substantial improvement" means that the improvements made to the property within a 30-month period beginning with the acquisition date exceed the acquisition cost of the property. To illustrate, if real property is bought by the QOF for $200, the QOF would need to put $201 of capital improvements into the property within the following 30-month period to satisfy the "substantially improved" test.

Designation of a QOZ

The U.S. Treasury Department has issued a list of the QOZs in all 50 states. Click here to locate the QOZs. See IRS Notice 2018-48.

Need for IRS guidance

Many of the provisions in the law are unclear in both scope and operation. The IRS has promised to provide guidance on many issues, such as the definition of "substantially all" and safe-harbor rules that will set forth the timelines under which a QOF can raise funds before investing in qualifying property.

State tax conformity

It remains to be seen whether states will adopt the deferral, basis increase and permanent exclusion provisions of investment in a QOF.

Conclusion

The QOF program can provide significant tax savings to taxpayers selling appreciated property, including both real property and other asset classes, as well as provide investment capital to spur economic development in distressed areas.

Timeline of Sample QOF Investment	
Day 1	Sell stock or property for gain of $200 and proceeds of $300
Within 180 Days	Invest the $200 gain in a QOF (need not invest all $300 of proceeds) Initial basis is $0
After 5 years	Increase basis by 10% of the gain = $20 If sell, gain is now $180
After 7 years	Increase basis by 5% of the gain = $10 If sell, gain is now $170
December 31, 2026	Tax on the $170 gain is due
Year 10	If you hold for 10 years, no tax due on the appreciated value on the original investment i.e. If value of property acquired by the QOF with the $200 cash investment is now worth $300, the increase in value of $100 is permanently tax-free.

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